Regional Outlook

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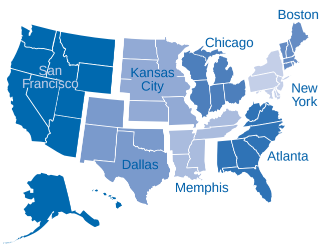

DIVISION OF INSURANCE

In Focus This Quarter

◆ ***Economic Conditions and Emerging Risks in Banking***—**After slowing significantly during the first eight months of 2001, the U.S. economy suffered an additional shock from the September 11 terrorist attacks on New York and Washington. As a result, most economists now expect the contraction in the economy that began in the third quarter to last at least through the end of the year. The depth and duration of this downturn will be determined by a confluence of factors, including the effects of monetary and fiscal stimulus and the degree of financial vulnerability in the consumer and business sectors.**

Overall, the U.S. banking industry appears well positioned to withstand a period of economic adversity and continue to provide credit to finance the economic recovery. This article discusses a combination of factors that may affect some banks—particularly those that rely on rapid loan or new account growth or that exhibit heightened credit risk profiles—in this more challenging economic environment. The article also identifies weaknesses that may exist in some previously booming metro areas as the local economies continue to slow. ***See page 3.***

By the Division of Insurance Staff

Regional Perspectives

◆ ***Atlanta***—**Declining growth in some areas with concentrations in the manufacturing and high-tech sectors has contributed to deterioration in credit quality and could adversely affect banking industry profitability.** ***See page 14.***

◆ ***Boston***—**The Region's insured institutions report healthy conditions. However, net interest margin compression and the potential for rising interest rate risk during a slowing economy could pressure earnings.** ***See page 17.***

◆ ***Chicago***—**Modest declines in credit quality have become more widespread among insured institutions. Continued slowing of economic conditions and ramifications from the September 11, 2001, attacks could lead to further weakening.** ***See page 20.***

◆ ***Dallas***—**Continued stress in the high-tech industry has contributed to softening in certain commercial real estate markets and to overall weakening in the Region's economy this year.** ***See page 24.***

◆ ***Kansas City***—**Farm banks in counties with relatively high reliance on government agriculture payments have exhibited higher levels of credit risk and are more vulnerable to any changes in these support programs.** ***See page 27.***

◆ ***Memphis***—**Credit quality, already showing some deterioration because of the Region's prolonged weak economic conditions, could decline further should the national economy continue to slow.** ***See page 30.***

◆ ***New York***—**Heightened economic uncertainty following September 11 has placed additional pressure on bank earnings and credit quality. However, the Region's insured institutions appear better positioned for an economic downturn than in the early 1990s.** ***See page 34.***

◆ ***San Francisco***—**Softening in some commercial real estate markets, deteriorating housing affordability, and increasing stress in the agricultural sector could adversely affect the quality of some real estate and farm loan portfolios.** ***See page 38.***

have high credit exposure if the median concentration ratio for either measure of credit exposure among banks and thrifts in the market ranked among the top quintile of all markets considered in the analysis.

The 21 markets share other characteristics. In all of these markets, rapid loan growth was supported largely by higher-cost and potentially more volatile noncore funding sources.[33] While banks and thrifts nationally have relied increasingly on these alternative funding sources, insured institutions in these metropolitan markets typically reported a greater reliance on noncore funding than institutions in most other areas of the country. Intense competition for local deposits has contributed to increased use of noncore funding. Competitive pressures also likely have affected loan pricing as well as underwriting standards at some insured institutions in these markets. In addition, new bank formation is a key factor driving competition, a trend that was most evident in the Southeast and West during the late 1990s. Levels of new bank formation have been particularly high in the **Grand Rapids, Las Vegas, Naples, Phoenix, Portland, Salt Lake City, Sarasota,** and **Seattle** markets.

Economic conditions in some of these markets may have weakened somewhat from the generally optimistic expectations that developed during the strong expansions in the late 1990s. Portland and **San Jose,** for example, already appeared to be in localized contractions by midyear 2001 because of considerable exposure to a weak high-tech manufacturing sector. **Atlanta, Memphis, Orlando,** and Phoenix also reported substantial slowing during 2000. Additionally, certain of the identified markets have high economic exposure to sectors that could be adversely affected by the national economic downturn. Las Vegas and Orlando remain heavily dependent on tourism, while markets with heavy exposure to a weakened air transportation sector, such as **Fort Worth** and Memphis, will be affected by reduced air travel and air cargo shipping. Also, real estate markets in many of these areas may be vulnerable to supply/demand imbalances as the economy slows.[34]

Obviously, other banking markets are not immune to the risks posed by a national economic downturn. In fact, many other markets share some of the same characteristics that may result from dynamic economic growth and rising credit exposure. Most of these additional metropolitan area markets are in the Southeast and West. Few are in the Northeast, an area of the country that was hit hard during the 1990–1991 recession (see box for a discussion of metropolitan areas at risk in the late 1980s).

Rapid growth and the acceptance of heightened levels of credit risk during the recent expansion enabled many banks to achieve extraordinary levels of profitability. However, the strategies, policies, and practices that were implemented during a more vibrant economy may not be appropriate today. Just as past economic strength in many metropolitan markets allowed banks more latitude in underwriting standards and credit administration practices, the current economic downturn suggests the need for increased attention to risk management functions.

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[33] Noncore funding sources include brokered deposits, certificates of deposit of $100,000 or more, Federal Funds purchased, securities sold subject to repurchase agreements, and other borrowed funds. The latter category consists largely of Federal Home Loan Bank advances.

[34] Real estate market conditions for many of these markets are discussed in "Slowing Economy Reduces Demand for U.S. Office Space," *Regional Outlook,* third quarter 2001. Some metropolitan areas were not considered in the analysis of real estate conditions because of limitations in real estate data availability; therefore, omission from this list does not suggest that specific real estate markets are not vulnerable.